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SUBJECT: WORLD BANK/IFC ON RESURGENCE OF STATE-OWNED ENTERPRISES

REF: A) CHENGDU 271; B) CHENGDU 263

**¶1.** (U) This cable contains sensitive but unclassified information - not for distribution on the Internet.

**¶2.** (SBU) SUMMARY: Chengdu IFC officials recently shared their assessment that state-owned enterprises (SOEs) have been on the resurgence since well before the financial crisis. They particularly emphasized the proliferation of "chengtou gongsi" or city investment corporations in Chengdu and Chongqing, contrasting with the almost complete absence of local-government SOEs in Sichuan as of the early 2000s. A range of factors have driven this process, they noted, including: cash strapped municipal governments seeking a platform to implement large development projects; some officials retaining a philosophical commitment to a state-supported conglomerate model for economic development(a la South Korea); corruption and nepotism; and the immaturity of the private sector. SOEs retain some notable advantages over private-sector companies, able to quickly deploy large resources without regard to commercial considerations, but the overall trend is ultimately "not in the country's interest."

Their greatest concern is that SOE expansion constricts the space for private-sector development. In their view, the pendulum will swing back against the SOEs again, although this could take several years. END SUMMARY.

**¶3.** (SBU) During a November meeting with Consul General (ref A), the head of the Chengdu office of the World Bank's International Finance Corporation (IFC), Lai Jinchang, and Charlie Cheng, IFC's Program Manager for Corporate Advice-Sustainability, discussed the resurgence of SOEs in recent years, both in Southwest China and nationwide. The SOE comeback predates the financial crisis and the stimulus package from which they have further benefited, they observed. Citing the example of Sichuan, they noted that more than a decade of privatization trends had left the province with an extremely small SOE presence by the early 2000s, comprising primarily a few national-level "key" industries and a handful of provincial SOEs. (Dongfeng Electric Corporation is an example of the former; liquor producer Wuliangye and television manufacturer Changhong (ref B) are examples of the latter.) However, the last few years has seen this trend reversed, they said, with a tendency toward the establishment of local (provincial and municipal) SOEs in a variety of fields, such as energy and infrastructure, and increasingly expansion into other sectors as well.

"Chengtou Gongsi":  
Platform for Development, or a Vehicle for Corruption?

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**¶4.** (SBU) The trend toward SOE resurgence has been particularly marked at the municipal level, where they observe the increasing dominance of the "chengtou gongsi" or city investment corporations. Lai and Cheng cited a range of factors driving the establishment of these local SOEs, including:

-- Cash strapped municipal governments, under pressure to accelerate economic growth, have turned to local SOEs as a platform to raise funds and implement major development projects. The chengtou gongsi model has given local governments "greater flexibility" to build infrastructure, and provide a means for borrowing large sums from banks -- a "very risky situation" about which the China Banking and Regulatory Commission (CBRC) has warned.

-- Many officials still believe in a statist conglomerate approach to economic development. While noting that less idealistic motives are often at work, some view the promotion of "national champions" as necessary to increase competitiveness, with South Korea often held up as a successful model.

-- Various forms of corruption and nepotism remain central. As a government official, if given the opportunity to set up a company, and then place yourself in a high-status, high-pay position within it, "why wouldn't you?" asked Lai.

-- The private sector remains immature. Governance and sustainability structures within private companies remains significantly underdeveloped, they noted, with most still running as "one-man shops," even if they have all the right structures on paper. They expressed optimism that this is changing as an increasing number of private-sector managers gain overseas experience and education. Nonetheless, they said, there is still a long way to go before private companies will be able to compete with SOEs on reputation, both for access to finance, and as an attractive option for the most talented employees.

#### "Probably Not a Good Trend": SOEs Encroach on Private Sector Space

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**¶** 15. (SBU) SOEs retain some notable advantages over private sector companies and will continue to have an important role in the Chinese economy, they said. Citing the example of post-quake reconstruction in Sichuan, they noted that SOEs were in a better position to respond than private sector companies, given their ability to deploy large resources quickly. Unlike private companies, they noted, SOEs could launch projects with little concern regarding the impact on their bottom lines. However, they assessed the overall trend as "not in the country's interest, but in the interest of many people."

**¶** 16. (SBU) Of greatest concern to them is the extent to which SOE expansion constricts the space for private-sector development. If the new local SOEs "were just doing infrastructure, it might be ok, but they have now gone way beyond that," said Lai. With no obligation to return earnings to shareholders, SOEs are often investing unproductively. He cited the example of a newly-established insurance company being run by state- and privately owned Sinopec that recently moved into office space within the same Chengdu office building as the IFC. "This should clearly be a (purely) private-sector investment, and it is a completely non-core business for them, but they have the political connections," said Lai.

#### An Anti-SOE Pendulum Swing on the Way?

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**¶** 17. (SBU) Given these criticisms, the IFC officials hope to see the pro-SOE trend reversed. Certainly, their role should not see further expansion, they said. The SOEs continued expansion within the domestic sphere, often by leveraging political connections, they fear, will only crowd out the private sector. (However, they saw Chinese SOE expansion into overseas markets as basically a positive long-term development for the national economy.) Despite their concerns regarding the current trajectory, the IFC officials nonetheless see the pro-SOE trends as ultimately a temporary swing of the pendulum. They expect that over the coming decade many will fail and the model will face increasing political backlash.

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